Supreme Court, U.S.
FILED
DEC 30 1996
CLERK

No. 96-235

In the Supreme Court of the United States

OCTOBER TERM, 1996

CALIFORNIA FRANCHISE TAX BOARD, PETITIONER

v.

STEPHEN B. MACFARLANE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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38 pp

QUESTION PRESENTED

Whether the government has the burden of proving that a taxpayer is not entitled to a deduction when an income tax claim is litigated in a bankruptcy case.

TABLE OF CONTENTS

	Page
Opinions below	1
Statutory provisions and rules involved	1
Statement	2
Discussion	6
Conclusion	15
Appendix A	1a
Appendix B	7a

TABLE OF AUTHORITIES

Cases:

BFP v. *Resolution Trust Corp.*, 511 U.S. 531 (1994)	10
Bacchus, In re, 718 F.2d 736 (5th Cir. 1983)	13
Betson v. *Commissioner*, 802 F.2d 365 (9th Cir. 1986)	9
Bonner Mall Partnership, In re, 2 F.3d 899 (9th Cir. 1993), cert. dismissed, 513 U.S. 18 (1994)	13
Briglevich, In re, 847 F.2d 759 (11th Cir. 1988)	
Brown, In re, 82 F.3d 801 (8th Cir. 1996)	7
Bull v. *United States*, 295 U.S. 247 (1935)	9, 11
Burnett v. *Houston*, 283 U.S. 223 (1931)	9
Butner v. *United States*, 440 U.S. 48 (1979)	10-11
Caravansary, Inc., In re, 821 F.2d 1413 (9th Cir. 1987)	13
Cobb v. *United States*, 135 B.R. 640 (Bankr. D. Neb. 1992)	7
Delaney v. *Commissioner*, No. 95-2066 (1st Cir. Nov. 1, 1996)	8
Dominguez, In re, 51 F.3d 1502 (9th Cir. 1995)	13
Federated Department Stores, Inc., In re, 135 B.R. 950 (Bankr. S.D. Ohio 1992), aff'd, 171 B.R. 603 (S.D. Ohio 1994)	7
Fullmer, In re, 962 F.2d 1463 (10th Cir. 1992)	7

Cases—Continued: Page

Goldblatt Bros., In re, 758 F.2d 1248 (7th Cir. 1985) 13
Gran, In re, 964 F.2d 822 (8th Cir. 1992) 7
Helvering v. *Taylor*, 293 U.S. 507 (1935) 8
IRS v. *Levy (In re Landbank Equity Corp.)*, 973 F.2d 265 (4th Cir. 1992) 7, 9-10
Krumpotich v. *Franchise Tax Bd.*, 31 Cal. Rptr.2d 896 (1994) 9
Placid Oil Co., In re, 988 F.2d 554 (5th Cir. 1993) 7
Premo, In re, 116 B.R. 515 (Bankr. E.D. Mich. 1990) 7
Resyn Corp. v. *United States*, 851 F.2d 660 (3d Cir. 1988) 7
Rockwell v. *United States*, 512 F.2d 882 (9th Cir.), cert. denied, 423 U.S. 1015 (1975) 9
TCL Investors, In re, 775 F.2d 1516 (11th Cir. 1985) 13
Tripplett, In re, 115 B.R. 955 (Bankr. N.D. Ill. 1990) 7
Unioil, In re, 962 F.2d 988 (10th Cir. 1992) 11
United States v. *Coleman American Cos.*, 26 B.R. 825 (Bankr. D. Kan. 1983) 7
United States v. *Terrell*, 75 B.R. 291 (N.D. Ala.), aff'd without opinion, 835 F.2d 1439 (11th Cir. 1987) 7-8
Welch v. *Helvering*, 290 U.S. 111 (1933) 8
Wilhelm, In re, 173 B.R. 398 (Bankr. E.D. Wis. 1994) 7

Statutes and rules:

Bankruptcy Code, 11 U.S.C. 101 *et seq.*:
11 U.S.C. 362(g) 10
11 U.S.C. 363(o) 10
11 U.S.C. 364(d)(2) 10
11 U.S.C. 502 10
11 U.S.C. 505 10

Statutes and rules—Continued:	Page
11 U.S.C. 547(g)	10
11 U.S.C. 1129(d)	10
28 U.S.C. 158	2
28 U.S.C. 158(a)(1)	2
28 U.S.C. 158(d)	2, 13
28 U.S.C. 1291	2, 13
28 U.S.C. 1292(b)	13
Fed. R. Bankr. P.:	
Rule 4003(c)	10
Rule 4005	10
Miscellaneous:	
9 J. Wigmore, *Evidence* (J. Chadbourn rev. 1981)	8
21 C. Wright & K. Graham, *Federal Practice and Procedure* (1977)	10

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v.

STEPHEN B. MACFARLANE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-11) is reported at 83 F.3d 1041. The opinion of the district court (Pet. App. 13-34) and the opinion of the bankruptcy court (Pet. App. 35-42) are unreported.

STATUTORY PROVISIONS AND RULES INVOLVED

In addition to the provisions of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure and the Internal Revenue Code that are set forth at Pet. App. 44-52, the following statutory provisions are involved in this case:

1. 28 U.S.C. 158 provides, in relevant part:

> (a) The district courts of the United States shall have jurisdiction to hear appeals
>
> (1) from final judgments, orders, and decrees;
>
> * * * * *
>
> and, with leave of the court, from interlocutory orders and decrees, of bankruptcy judges entered in cases and proceedings referred to the bankruptcy judges under section 157 of this title. * * *
>
> * * * * *
>
> (d) The courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders and decrees entered under subsections (a) and (b) of this section.

2. 28 U.S.C. 1291 provides, in relevant part:

> The courts of appeals (other than the United States Court of Appeals for the Federal Circuit) shall have jurisdiction of appeals from all final decisions of the district courts of the United States, * * * except where a direct review may be had in the Supreme Court.

STATEMENT

The United States adopts the Statement contained in the Petition with the following additions:

1. a. After the debtor filed his objection to the state tax claim, a hearing was held by the bankruptcy court on March 15, 1993. At that hearing, the bankruptcy court announced its conclusion that (i) the

proof of claim filed by the state agency "is prima facie valid under the Bankruptcy Rules" but (ii) that the debtor had filed "competent evidence" that would support a conclusion that no tax was owed and (iii) that "the prima facie validity" of the tax claim therefore "has been rebutted" (App., *infra*, 2a-3a). The court then held that the ultimate burden of "proving by a preponderance of the evidence the factual basis for [the tax] claim" rests on the state agency rather than on the debtor (*id.* at 3a).

Having determined that the burden of proof on the tax claim rests ultimately on the state agency, the court concluded that (App., *infra*, 3a)

> there ought to be a window of time in which the [state agency] is allowed to conduct subsequent discovery as it believes it needs to support its claim. And then we'll have an evidentiary hearing and determine what the allowed amount of the claim should be.

The court set "a status conference" for the case for July 12, 1993 (*id.* at 5a).

b. Before the date of the status conference, the debtor filed a motion for summary judgment on his objection to the state tax claim (Pet. App. 15-16). That motion, which was accompanied with documentary evidence and deposition testimony, contained a statement of the uncontroverted facts that the debtor claimed entitled him to summary judgment (App., *infra*, 17a). The motion was opposed by the state agency, which relied on the same materials submitted by the debtor (Pet. App. 15-16).

At the status conference held on July 12, 1993, the court announced that "[t]he uncontroverted facts in this record" (App., *infra*, 8a) support the conclusion

that no tax is owed. The court stated that if there had been "controverting facts" it might have reached a different conclusion but that "the uncontroverted evidence at this point in time" required judgment to be entered in the debtor's favor on his objection to the state tax claim (*ibid.*). In explaining its ruling at the July 12 hearing, the court stated (*id.* at 17a):

> I went through the list of the assertedly uncontroverted facts set out in exhibit 1 to the notice of this motion filed by the debtor and found that I could agree with each of those based upon the statements I've already made * * *.

Having thus ruled on the "motion filed by the debtor," the court directed the debtor's counsel to "prepare a proposed formal order" (*ibid.*).

The formal order thereafter entered by the bankruptcy court states (Pet. App. 41):

> The California Franchise Tax Board has had an adequate opportunity for discovery. The only evidence has been offered by the Debtor. * * * The evidence offered by the Debtor is not controverted by the California Franchise Tax Board. Accordingly the Court concludes that there is no issue of material fact raised by the evidence before the Court which is in reasonable dispute.

Expressing the view that the uncontroverted facts require the conclusion that no tax was owed, the court entered judgment in the debtor's favor on the state tax claim (*ibid.*).

2. On appeal, the district court agreed with the bankruptcy court that the state agency has the ultimate burden of proof on state tax claims in bankruptcy cases (Pet. App. 23). The district court fur-

ther stated that, on the record before it, the "findings of fact" recited in the bankruptcy court's order were not clearly erroneous (*id.* at 25-30). The district court concluded, however, that the state agency presented evidence that "creates a genuine issue of triable fact" on these material facts and that summary judgment was therefore inappropriate (*id.* at 31). The court explained (*id.* at 32):

> Although the [state agency] has the ultimate burden of proof to establish to what extent the funds advanced * * * were for the purpose of a tax shelter, the Board has pointed to sufficient evidence in the record to create a triable issue that some of the funds were not loans and were used to generate a tax loss.

"Viewing all inferences that can be drawn from the excerpts of the record * * * in a light most favorable to the [state agency]," the district court held that material issues of fact were in genuine dispute (*id.* at 34) and therefore "reverse[d] the bankruptcy court's grant of summary judgment" (*ibid.*).

3. Both the debtor and the State appealed. The court of appeals noted that there is "a jurisdictional concern that the district court's reversal of the bankruptcy court's judgment is not a final order because further proceedings in bankruptcy court are contemplated" (Pet. App. 6). Taking what it described as "a pragmatic approach," the court held that it would assume jurisdiction in this case even though the district court's order "remands for further proceedings in the bankruptcy court" (*id.* at 6-7).

Reaching the merits, the court of appeals agreed with the analysis and conclusions of the bankruptcy court and directed that judgment be entered in the

debtor's favor (Pet. App. 7-11). In so ruling, the court expressed uncertainty as to whether the case had been decided below after an evidentiary hearing or on summary judgment. The court of appeals suggested that an evidentiary hearing may have occurred because the findings of fact recited in the order of the bankruptcy court appear to have "resolved factual disputes" (*id.* at 10). The court stated that, on the record before it, the findings recited in the bankruptcy court order "are not clearly erroneous" (*ibid.*). The court further held that, "even if summary judgment standards are applied [in this case], we agree with debtor that the bankruptcy court's decision should be affirmed" because no "genuine issues of material fact" exist (*id.* at 11). The court of appeals therefore reversed the judgment of the district court and remanded for entry of judgment in favor of the debtor (*ibid.*).

DISCUSSION

The holding of the court of appeals that the taxing authority has the burden of proof on tax claims in bankruptcy cases is in direct conflict with decisions of other circuits. This case does not provide a suitable vehicle for resolving the conflict on this important and recurring question, however, for the court of appeals lacked jurisdiction over the appeal from the district court order that denied summary judgment in this case. In bankruptcy litigation, as in other civil litigation, an order denying a motion for summary judgment on the ground that material issues of fact remain in genuine dispute is not a "final" order from which an appeal may be taken.

Because the court of appeals lacked jurisdiction, the judgment should be vacated and the case remanded

to the bankruptcy court for further proceedings pursuant to the order of the district court. Petitioner, however, has not suggested that the absence of jurisdiction in the court of appeals is a basis for this Court's review of the decision below. And, the question that *is* framed in the petition—the proper allocation of the burden of proof on tax claims in bankruptcy cases—is not appropriate for review on this petition because the court of appeals had no jurisdiction to consider it.

1. The court of appeals correctly noted that its holding that the taxing authority has the burden in bankruptcy cases of proving the correctness of a tax determination is consistent with the decisions of three other courts of appeals (Pet. App. 8, citing *In re Placid Oil Co.*, 988 F.2d 554, 557 (5th Cir. 1993); *In re Gran*, 964 F.2d 822, 827-828 (8th Cir. 1992); *In re Fullmer*, 962 F.2d 1463, 1466 (10th Cir. 1992) (dictum); see also *In re Brown*, 82 F.3d 801, 805 (8th Cir. 1996) (dictum)) but conflicts with the decisions of two other circuits (Pet. App. 8, citing *Resyn Corp.* v. *United States*, 851 F.2d 660, 663 (3d Cir. 1988); *IRS* v. *Levy (In re Landbank Equity Corp.)*, 973 F.2d 265, 268-272 (4th Cir. 1992)).[1] This direct conflict among the cir-

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[1] The decisions of the lower courts reflect the division among the circuits. Compare, *e.g.*, *In re Wilhelm*, 173 B.R. 398 (Bankr. E.D. Wis. 1994); *In re Federated Department Stores, Inc.*, 135 B.R. 950, 957-958 (Bankr. S.D. Ohio 1992), aff'd, 171 B.R. 603, 607 (S.D. Ohio 1994); *In re Premo*, 116 B.R. 515 (Bankr. E.D. Mich. 1990); *United States* v. *Coleman American Cos.*, 26 B.R. 825 (Bankr. D. Kan. 1983) (tax authorities, like other creditors, must bear burden of proof to establish their claims), with, *e.g.*, *Cobb* v. *United States*, 135 B.R. 640, 641 (Bankr. D. Neb. 1992); *In re Tripplett*, 115 B.R. 955, 964 n. 11 (Bankr. N.D. Ill. 1990); *United States* v. *Terrell*, 75 B.R. 291

cuits concerns a recurring issue of substantial importance to the administration of the tax laws.

a. In litigation involving federal tax liabilities, the taxpayer bears the ultimate burden of persuasion.[2] More than sixty years ago, this Court stated in *Helvering* v. *Taylor*, 293 U.S. 507, 515 (1935), that "[u]nquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid." See also *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933). As the First Circuit has recently explained, "[t]he rationale for this rule is more deeply rooted than the conventional regimen that places the burden of proof on the moving party." *Delaney* v. *Commissioner*, No. 95-2066 (Nov. 1, 1996), slip op. 6:

> The Supreme Court has held that the Commissioner's "ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong." *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); *see also United States* v. *Janis*, 428 U.S. 433, 439 (1976); *Estate of Todisco* v. *Commissioner*, 757 F.2d 1, 6 (1st Cir. 1985) (the basic rule in all tax cases places the burden of proof with the taxpayer). * * * [I]n a tax deficiency suit "the burdens of going forward and of ultimate persuasion are

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(N.D. Ala.), aff'd without opinion, 835 F.2d 1439 (11th Cir. 1987) (burden of proof is governed by applicable nonbankruptcy law and, in tax cases, burden lies with taxpayer).

[2] The party who bears the burden of proof in litigation bears the ultimate burden of persuasion or the risk of nonpersuasion. 9 J. Wigmore, *Evidence* § 2485 (J. Chadbourn rev. 1981). Although the burden of production may shift during the course of a lawsuit, the burden of proof is fixed as a matter of law and never shifts. *Id.* § 2489.

> always on the taxpayer and never shift to the Commissioner." [*United States* v. *Rexach*, 482 F.2d 10, 16-17 (1st Cir.), cert. denied, 414 U.S. 1039 (1973).]

The present case involves a claim for additional state income taxes arising from the disallowance of asserted bad debt deductions. In cases involving federal taxes, it is well established that the taxpayer always bears the burden of proof in establishing a claim of entitlement to a deduction. See, *e.g.*, *Bull* v. *United States*, 295 U.S. 247, 260 (1935); *Burnet* v. *Houston*, 283 U.S. 223, 227-228 (1931).[3] This same allocation of the burden of proof to the taxpayer applies under the state law applicable to the state tax involved in this case (Pet. App. 7, citing *Krumpotich* v. *Franchise Tax Bd.*, 31 Cal. Rptr.2d 896, 899 (1994)) and, evidently, under the laws of all other States (Am. State of Arizona, et al., Br. 5 n.2).

b. The court of appeals erred in this case in concluding that this burden of proof should be shifted from the taxpayer to the government simply because the tax issue arises in the bankruptcy context. As this Court noted in *Bull* v. *United States*, 295 U.S. at 260, the usual procedure for recovery of debts is "reversed" in the field of taxation in that "the burden of proof, normally on the claimant, is shifted to the taxpayer." This allocation of the burden of proof in tax cases is governed by substantive law, not by any rule of bankruptcy procedure. *In re Landbank Equity*

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[3] In federal tax cases litigated outside of the bankruptcy context, the Ninth Circuit has routinely adhered to that rule. See, *e.g.*, *Betson* v. *Commissioner*, 802 F.2d 365, 367 (1986); *Rockwell* v. *United States*, 512 F.2d 882, 885-886, cert. denied, 423 U.S. 1015 (1975).

Corp., 973 F.2d at 269-271. See 21 C. Wright & K. Graham, *Federal Practice and Procedure* § 5122 (1977).

The court of appeals acknowledged that "[t]he bankruptcy code is silent on the allocation of the ultimate burden of proof in this case" (Pet. App. 9).[4] Because there is no "clear and manifest" (*BFP* v. *Resolution Trust Corp.*, 511 U.S. 531, 544 (1994)) indication in the Bankruptcy Code of any intent to displace substantive state and federal law in the enforcement of tax claims, allocation of the burden of proof to the taxpayer under the applicable provisions of substantive law should not have been discarded by the courts below.

The court of appeals sought to justify its decision in this case as an effort to "balance the equities 'between the Board and the other creditors of Debtor's estate'" (Pet. App. 9). But the court's concerns about "equities" between claimants does not justify a refusal to enforce substantive state and federal tax law. Here, as in *Butner* v. *United States*, 440 U.S. 48,

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[4] Neither 11 U.S.C. 502 of the Bankruptcy Code, which governs the allowance of claims generally, nor 11 U.S.C. 505, which authorizes the bankruptcy courts to adjudicate tax disputes, contains any provision regarding allocation of the burden of proof. Compare 11 U.S.C. 362(g) (assigning burden of proof in challenges to automatic stay); 11 U.S.C. 363(*o*) (in hearing on use of property, assigning burden on adequate protection to trustee); 11 U.S.C. 364(d)(2) (in hearing on obtaining credit, assigning trustee burden on adequate protection issue); 11 U.S.C. 547(g) (assigning burden with respect to avoidability of certain allegedly preferential transfers); 11 U.S.C. 1129(d) (assigning to government burden of proving claim of tax avoidance as principal purpose of plan). See also Fed. R. Bankr. P. 4003(c) (party objecting to exemption bears burden); Fed. R. Bankr. P. 4005 (burden assigned to party objecting to discharge).

56 (1979), "undefined considerations of equity provide no basis for adoption of a uniform federal rule" in bankruptcy that departs from generally applicable rules of substantive law. Furthermore, as Amici State of Arizona, et al., explain (Am. Br. 9-10), the burden of proof has been assigned to the debtor in *non*-tax disputes in bankruptcy cases when applicable nonbankruptcy law assigns that burden to the party in the debtor's position. See, *e.g.*, *In re Unioil, Inc.*, 962 F.2d 988, 994 (10th Cir. 1992) (debtor had burden of proving accord and satisfaction as mandated by applicable state law). It is thus not a special dispensation to taxing authorities in bankruptcy cases to apply the rules allocating the burden of proof that are established under substantive, nonbankruptcy law. Instead, it is a distinctive discrimination against the taxing authority to refuse to apply the allocation rules established under applicable nonbankruptcy law.

c. The proper allocation of the burden of proof on tax claims in bankruptcy cases is an issue of substantial recurring importance in the administration of the tax laws. The Internal Revenue Service files more than 100,000 proofs of claim in bankruptcy cases each year seeking to recover several billion dollars of taxes. If the Service were required to bear the burden of proof on tax claims in bankruptcy cases, it would potentially be necessary for the government to engage in substantial discovery and case preparation in vast numbers of cases to meet pro forma objections that the government must "prove up its case." Such a requirement can not be reconciled with this Court's holding in *Bull* v. *United States*, 295 U.S. at 260, that "the usual procedure for the recovery of debts is reversed in the field of taxation" and that "the burden

of proof, normally on the claimant, is shifted to the taxpayer."

A rule that allowed taxpayers in bankruptcy to avoid the burden of proof would encourage abusive use of the bankruptcy courts. It would make bankruptcy a favorable arena in which to defend questionable deductions and would materially impede the effective enforcement of the revenue laws.

2. In its present posture, this case is not a suitable vehicle for resolving the important and recurring question of the proper allocation of the burden of proof on tax claims in bankruptcy cases. Although the proceedings that occurred in the bankruptcy court are not clearly reflected in the orders of the courts below, it appears from examination of the record that (i) the debtor moved for summary judgment on his objection to the state tax claim, (ii) the bankruptcy court granted summary judment to the debtor based upon the "uncontroverted facts set out in * * * this motion" (App., *infra*, 17a), and (iii) the form of order prepared by debtor's counsel, and entered by the court, contained both a recitation of "findings" and a statement by the bankruptcy court that "[t]he evidence offered by the Debtor is not controverted" and "that there is no issue of material fact" for the court to resolve (Pet. App. 41). On appeal from that order, the district court reversed the grant of summary judgment by the bankruptcy court because there was "sufficient evidence in the record to create a triable issue" on the tax claim (*id.* at 32) and material issues of fact thus remained in genuine dispute (*id.* at 34).

The posture of the case at the conclusion of these proceedings in the district court was thus simply that a motion for summary judgment had been denied. A

district court order that denies a motion for summary judgment on the ground that material issues of fact remain in controversy is not a "final" order from which an appeal may be taken under 28 U.S.C. 158(d) or 28 U.S.C. 1291. See, *e.g.*, *In re Caravansary, Inc.*, 821 F.2d 1413, 1414 (9th Cir. 1987); *In re TCL Investors*, 775 F.2d 1516, 1519 (11th Cir. 1985); *In re Goldblatt Bros.*, 758 F.2d 1248, 1250-1251 (7th Cir. 1985); *In re Bacchus*, 718 F.2d 736, 737 (5th Cir. 1983).[5]

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[5] The court of appeals cited several decisions from its circuit that embody what the court described as a "pragmatic approach" to the finality question (Pet. App. 6). Those cases, however, are inapposite. For example, in *In re Dominguez*, 51 F.3d 1502 (9th Cir. 1995), the court stated that, "[a]lthough we ordinarily lack jurisdiction when the lower appellate decision remands for further factual findings related to a central issue raised on appeal, we may assert jurisdiction if the appellate 'issue is *legal* in nature and its resolution either 1) could dispose of the case or proceeding and obviate the need for factfinding; or 2) would materially aid the bankruptcy court in reaching its disposition on remand.'" *Id.* at 1506-1507, quoting *In re Bonner Mall Partnership*, 2 F.3d 899, 904 (9th Cir. 1993), cert. dismissed, 513 U.S. 18 (1994). The issue decided in the courts below in the present case, however, was whether material issues of fact were in genuine controversy—which was a factual, not legal, issue. There was no legal dispute about whether the issues of fact, if in genuine controversy, would be material. Thus, even under the Ninth Circuit's "pragmatic" approach, the court of appeals lacked jurisdiction because "the lower appellate decision remands for further factual findings related to a central issue raised on appeal" (*ibid.*). See *In re Caravansary, Inc.*, 821 F.2d at 1414.

Moreover, the Ninth Circuit's overall attempt to craft a special, "pragmatic" approach to the question of finality in bankruptcy cases has been a highly dubious enterprise. The decisions cited by the court of appeals in this case (Pet. App. 6-7) suggest an effort to apply criteria similar to those governing interlocutory appeals under 28 U.S.C. 1292(b). But, while the

The court of appeals therefore lacked jurisdiction over the appeal in this case.

Because the court of appeals lacked jurisdiction, the issue of the proper allocation of the burden of proof should not have been reached on appeal. Instead, the appeal should have been dismissed. Because the appeal should have been dismissed, this case does not present an appropriate opportunity for this Court to review the decision below on the merits. In particular, the question presented in the petition for a writ of certiorari cannot properly be addressed in this case at this time.

The relief that would be appropriate in this context would be an order vacating the judgment of the court of appeals for lack of jurisdiction and remanding the case to the bankruptcy court for further proceedings. Although petitioner has not requested such relief, it would, in our view, be useful (see note 5, *supra*).

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latter category of appeals are clearly optional and discretionary in nature, a party is placed at a substantial risk of losing its right to appeal under the Ninth Circuit's "pragmatic" approach if it forgoes taking an immediate appeal from a seemingly interlocutory order in bankruptcy that may meet the Ninth Circuit's flexible standard of finality. Hence, the erosion of a reliable finality criterion tends to spawn appeals from interlocutory orders—as in the present case.

CONCLUSION

The petition for a writ of certiorari should be denied or, if granted, the judgment of the court of appeals should be vacated for lack of jurisdiction and the case remanded for further proceedings. If the case is set for briefing and argument, the parties should be asked to address, in addition to the question presented in the petition, whether the court of appeals lacked jurisdiction in this case.

Respectfully submitted.

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DECEMBER 1996

APPENDIX A

[167]

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

U.S. Courthouse
940 Front Street
San Diego, California 92189
Department No. 4

IN THE MATTER OF: STEPHEN MACFARLANE,
DEBTOR

HEARING RE: OBJECTION TO CLAIM

March 15, 1993

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Hon. PETER W. BOWIE, Judge

Federal Court Reporting
By: Kathleen Cheyne
940 Front Street
San Francisco, California 92189
(619) 726-8053

* * * * *

[169]

San Diego, California - Monday, March 15, 1993 - 2:30 P.M.

* * *

The Clerk: 90 11375, Stephen Macfarlan, objection to claim.

The Court: Appearances.

Mr. Martin: Good afternoon, your Honor. Elmer Martin appearing for the debtor.

Mr. Sgherzi: Good afternoon, your Honor. Anthony Sgherzi, Deputy Attorney General, appearing on behalf of the State Board of Equalization.

The Court: Mr. Sgherzi. Would you like a preliminary assessment?

Mr. Sgherzi: That would be helpful.

The Court: All right. I've reviewed the volum[e]s of moving and opposing papers, and where I come out is as follows on the threshold issues. It appears to me as follows: first off the franchise tax board has filed a proof of claim. Their proof of claim is prima facie valid under the bankruptcy rules and therefore is treated that way. The debtor has filed an objection to claim. The debtor has provided competent evidence tending to challenge that there was in fact a debt that existed in 1988 and 1989. Further the debtor has provided competent evidence to establish that the debt was worthless in 1988 and 1989.

What that means then as far as this court is concerned is that the presumption of validity, the prima facie validity, of F.T.B.'s claim has been rebutted. Now we get to [170] the issue that always divides the taxing authorities and debtors; and that is who has the burden at this juncture.

Do we have the non-bankruptcy burden or do we have the bankruptcy burden. It is this court's view after having reviewed a number of cases over the last several years in which this issue has been tested that in fact in the bankruptcy arena the taxing authority having submitted a proof of claim is a claimant or creditor claimant like other creditor claimants and therefore has the burden once the prima facie validity has been rebutted, proving by a preponderance of evidence the factual basis for its claim.

Now, having concluded that and because the burden issue is a threshold issue that needs to be resolved, it's my view that there ought to be a window of time in which the franchise tax board is allowed to conduct subsequent discovery as it believes it needs to support its claim. And then we'll have an evidentiary hearing and determine what the allowed amount of the claim should be.

All right. Who wants to be heard first? Mr. Martin, you want to be heard? It's your objection to claim. You agree with everything except giving him a window of time to conduct discovery.

Mr. Martin: Well, I don't—Actually I don't disagree with anything your honor said. I don't know of anything that they're going to find that we haven't put in the papers we've already put forward, but we're

willing to make time available to them, if that's the court's wish.

The Court: Mr. Sgherzi.

[171]

Mr. Sgherzi: Your Honor, based on the court's preliminary assessment, I would appreciate at least the opportunity to see if we can somehow persuade the court that there's merit in the points and authorities that we filed in terms of not only the burden but actually the underlying evidence to sustain that.

The Court: Well, I've made my threshold rulings. So at this point in time the burden is yours to prove it. What window of time do you think will be reasonable for you? Do you think we can take 30 days to review it and we hold a status conference in 30 days or something?

Mr. Sgherzi: If we are going to do discovery, naturally we'll probably do depositions or requests for production of certain documents and so on. I would like rather than have to come back here and continue to expend time, I would say 90 days should be a reasonable amount of time in which we can either conclude that we have something or we don't.

The Court: All right. With respect to the burden issue, I understand the arguments on both sides and have faced it before, particularly with the I.R.S., and this is where I come out siding with the primo line of cases, if you will.

Mr. Martin, Can you live with that window?

Mr. Martin: Yes, your honor.

The Court: All right. Why don't we set a status conference for roughly 90 days, and that should not preclude either of you from doing what you feel you need to do in a shorter period of time.

Mr. Sgherzi: Sure.

[172]

The Court: Because everybody has an interest in trying to get this resolved.

The Clerk: July 12th at 2:00 o'clock.

The Court: You want to go all the way to July? That's about 120 days.

The Clerk: June 14th at 2:00 o'clock.

Mr. Martin: Your Honor, I'm going to be out of state on June 14th in a program at Notre Dame on how to try trials in bankruptcy cases so I won't be available on June 14th.

The Clerk: June the 21st at 2:00 o'clock.

Mr. Martin: June 21st I'm serving as a pro team judge in superior court.

The Court: Maybe we ought to go back to July the 12th.

Mr. Martin: What day of the week does that fall on?

The Clerk: Monday.

The Court: July the 12th, 2:00 p.m.

Mr. Martin: That's fine with me.

The Court: Okay.

Mr. Sgherzi: Thank you.

Mr. Martin: Thank you.

[173]

State of California)

County of San Diego)

I, Kathleen Cheyne, a shorthand reporter, do hereby certify that the foregoing hearing was taken before me at the time and place herein named; that said hearing was reported by me in shorthand and then transcribed through computer-aided transcription, and the foregoing transcript contains a true record of the said hearing.

I do further certify that I am a disinterested person and am in no way interested in the outcome of this action.

In witness whereof, I have hereunto set my hand on the 21st day of July, 1993, at San Diego, California.

/s/ KATHLEEN CHEYNE

KATHLEEN CHEYNE

APPENDIX B

[69]

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

U.S. Courthouse
940 Front Street
San Diego, California 92189
Department No. 4

IN THE MATTER OF: STEPHEN MACFARLANE,
DEBTOR

HEARING RE: ORJECTION TO CLAIM AND MOTION FOR SUMMARY DETERMINATION DENYING CALIFORNIA FRANCHISE TAX BOARD CLAIM

July 12, 1993

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Hon. PETER W. BOWIE, Judge

Federal Court Reporting
By: Kathleen Cheyne
940 Front Street
San Diego, California 92189
(619) 726-8053

* * * * *

[71]

San Diego, California - Monday, July 12, 1993 - 2:00 P.M.

* * *

The Clerk: 90 11375, Stephen Macfarlane, objection to claim and motion for summary determination denying California franchise tax board claim.

The Court: Appearances.

Mr. Martin: Good afternoon, your Honor. Elmer Martin appearing for the debtor.

Mr. Sgherzi: Good afternoon, your Honor. Anthony Sgherzi, Deputy Attorney General, appearing on behalf of the Franchise Tax Board.

The Court: Mr. Martin. That's the smallest piece of paper you've gotten in this case, isn't it?

Mr. Martin: And there's nothing on it, too. Well, does your honor have a tentative?

The Court: I do.

Mr. Martin: Could we hear it?

The Court: My view of this proceeding is as follows: that while if I had facts to support it, I might have some question about what went on here as being embezzlement by Mr. Cheng and thus qualifying as a loss rather than a debt.

The uncontroverted facts in this record as established particularly by Ms. Szuetenback in both her declaration and her transcript of her deposition establish that [72] these were loans.

Now, whether if I had controverting facts, I might conclude that if I saw more evidence. I can't say. But the uncontroverted evidence at this point in time is that they were loans.

Now, in as much as they were loans and in as much as we then come upon the question of whether at some point in time they became worthless, is really the controlling question. Because to the extent they were loans, they were an obligation to pay, and that would therefore qualify them as debts, which if they became bad, meaning they became worthless, would entitle the debtor to the deductions that the debtor has claimed.

The amounts have not been challenged. Ms. Szuetenback in her deposition testifies both as to the amounts and as to the evidence of the loans, the additional checks that were—that were other than the ones discussed with Mr. Macfarlane in his deposition. And if you add those up, there's been no facts established to controvert the facts asserted by the debtor with respect to the dollar amounts claimed in either the '88 or '89 tax returns. So the issue then becomes, when did it become worthless.

The state has argued that how can Mr. Macfarlane say it became worthless in '88 when he didn't even know that it became worthless. But we have Mr. Cheng who instructs Ms. Szuetenback to take it as a bad debt loss because he has an [73] inability to pay, that she's got personal knowledge, as does Ms. Joyce, that Mr. Cheng does not have the ability to pay at that point in time.

Under all the circumstances and accepting that whether or not a debt becomes worthless when a debt becomes worthless, is a question of fact. The uncontroverted facts established that it became worthless in '88 as to '88 and by the end of '89 as to '89.

And the next question is, well, but if Mr. Macfarlane didn't owe that, how can he claim that that was in fact worthless. But we have the fact that Mr. Cheng

acknowledges it by directing its inclusion in the '88 and '89 tax returns, but we also have Mr. Cheng having Mr. Macfarlane's power of attorney and the ability to recognize that in the very office where you're preparing Mr. Macfarlane's tax return. So somebody on behalf of Mr. Macfarlane was authorized to and apparently did recognize that in fact the obligations to Mr. Cheng in '88 and again in '89 had become worthless.

Now, the state has suggested that Mr. Macfarlane could have had no expectation of repayment in '89, having signed the '88 tax return because he knew at least at that point in time that there was no way that Mr. Cheng could repay him. Well, one, that fact is not at all clear. Secondly, the date on which the '88 tax return was signed was in October of '89. Third, is that the premise of the state appears to be that the [74] debt had to be a good debt at the start of the year and termed worthless sometime during the year.

In point of fact, we could make a loan to somebody, as banks often do, even at a time when the banks are administratively or accountantwise insolvent, make loans or advances by way of credit card accounts to people who are themselves insolvent and still do it notwithstanding their circumstances. The fact that you could say that I knew that he could not pay back last year's obligations, one does not establish that he couldn't pay back the next year's obligations on new loans made in 1989, but, secondly, there is at least the value advance in the loan amounts which establishes value and at least momentarily inability to repay within that window of time.

So however unreasonable one might say Mr. Macfarlane's expectations were and recognizing that Mr. Macfarlane had a real difficulty distinguishing

between what's a loan and an investment, nevertheless under all the circumstances, it's the court's ruling under a tentative basis, and I'll hear from Mr. Sgherzi on it, that the debtor's motion ought to be granted.

Mr. Martin: Thank you, your Honor.

Mr. Sgherzi: I guess by now the court's pretty familiar, after reading all of these papers, the state's position. I think there are a lot things that are clear. I think—but there are also very many things that are not clear.

[75]

First of all, I think you have to take a look at what the debt is. First of all, we don't have a situation where there was one particular circumstance in which the debtor gave Cheng or any of the associates money. The facts clearly indicate that the debtor provided Cheng and the associates with an all-inclusive power of attorney. Which meant they could have taken the money out at any time; they could have done whatever in fact they wanted to do with it.

Under those circumstances, I don't see how anyone else can indicate that there was an intent on the part of the debtor to make a loan. It just does not add up. Cheng had an all-inclusive power of attorney, and the fact that—

The Court: Well, let me interrupt you for a minute.

Mr. Sgherzi: Sure.

The Court: Because one of the documents on which I rely to establish that is the letter from Mr. Cheng to Mr. Macfarlane in January of '87 which says, you know, we've talked about a loan to me. We've talked about your investing in this information system, which was not Cheng at the time. It was the

other one. Altear (phonetic spelling) I think it was called. But at this point in time we went to treat it as a personal loan and deal with it this way. And as the process of Altear solidifies, then we'll talk about investing. And that's a threshold document which suggests, here is where money is going, [76] this is what Macfarlane understands he's doing and what he thinks he's getting into.

Mr. Sgherzi: Well, I understand that. That probably is in effect to one particular transaction. But my understanding of the way this whole thing went down is that there were multiple transactions over a period of time. I think the evidence shows, and if the court takes look at page seven.

The Court: Of?

Mr. Sgherzi: Of my last—

The Court: Page seven of which document?

Mr. Sgherzi: Responsive creditor franchise tax board's objection to a complaint in the July 2nd document.

It basically indicates that he gave an all-inclusive power of attorney; he had signatory power over all the checking accounts.

Now, when someone says on a particular occasion that money is being used for purposes of a loan, I don't think you can assume that that money is being used for purposes of a loan with respect to every transaction which takes place during 1988 and 1989. My reading of the evidence certainly doesn't bear that out at all.

The Court: But then when we add to the January, '87 letter all the copies of checks, the subsequent notes in '87; there was a note in February of '87; there was a note in September; there was a note in December; there was the undated [77] million dollar note;

there were multiple copies of checks that have on the memo line "loan."

Mr. Sgherzi: Well, I understand what the court is saying, but to me that's not perfectly clear. Because, for example, on page 11 of the same document I referred to earlier, Macfarlane tells Cheng, "I need a tax shelter." The only purpose of a tax shelter that I'm aware of is to generate a loss. If you're going to generate a loss, I don't see how there would be any reasonable expectation of repaying it. It's just totally inconsistent.

This is testimony that came from the debtor's own mouth. It's nothing I said. His counsel was present. He had the opportunity to rehabilitate if there's a problem. This came from his deposition. How can you have a reasonable expectation of repayment on one hand and enter into a tax shelter, which the court is well aware of. The only purpose would be—

The Court: If you show me that any of that money went into the wind power systems, which is what that particular tax shelter was according to Mr. Macfarlane, which was not in '87 and not in '88 and not in '89, then we might talk about what's being excluded. But this was part of the problem and this is part of the threshold issue which, of course, the state doesn't like my March ruling on, and I understand that. I mean, I recognize that there is a split in authority, but I ruled in March and my position remains the same; and that is that the [78] claim filed by the state was prima facie valid. It was rebutted by the debtor. The state therefore has the burden of going forward, notwithstanding that it is a taxing authority, the state in non-bankruptcy circumstances would able to require the debtor, the taxpayer, to carry the burden of proof.

Mr. Sgherzi: Right. I understand completely what the court is saying, but I think you can see why the problem is the way it is. When you put that type of a burden on the state, it's almost impossible to enable it to do its job. It should make no difference whether it's in tax court or in bankruptcy court. I think the substantive law requires that the debtor prove his case, entitlement to a bad debt deduction, entitlement to anything else.

The Court: Well, I disagree with you in several particulars. One, I think there are probably—I mean, I don't know, but based upon the record I've seen, it seems to me that if there's evidence out there that in fact this was an embezzlement by Cheng, there was discovery that the state could have undertaken to establish the fact that it was embezzlement rather than a series of loans.

Secondly, that there were documents or amounts that don't add up and that show that at least some portions of the transactions are not accountable for as loans by any documentation, by any testimony and the like. None of that was done in the intervening months.

[79]

Mr. Sgherzi: I understand. I thought the record was clear. I spoke to my client. My client believed the record was clear that there was substantial doubt in terms of the alleged bad debt deductions during 1988 and 1989. But I understand if we're just talking about a particular event or two or three particular events that took place in 1988 and 1989, then I think we're dealing with something else. But when someone has an all-inclusive power of attorney and enables them to get money out whenever they want and to place it in this account and place it in that account,

that puts a real serious burden on trying to determine what exactly happened.

I believe that's why the law is the way it is outside of the bankruptcy context, which requires them to prove—

The Court: Well, that's right. Outside the bankruptcy context, that's how the burden would be. But there was nothing to prohibit your office from, for instance, going and taking Ms. Szuetenback's deposition and saying, all right now let's take this transaction and let's add up the sum totals, and what do you have that supports your contention that this was a loan or wasn't a loan and go through and establish what facts you contend are either, one, genuine issues of material fact that precludes this entry of judgment on this objection to claim, or two, establish that in fact it was an embezzlement, or that it wasn't a loan; it was something [80] else. Those opportunities were there.

Mr. Sgherzi: I understand that, but I just review the evidence somewhat differently. I think that there is still quite a bit of doubt in terms of what happened. I understand the court indicates it's my burden, but again I believe that—

The Court: Therein lies the crux of the problem.

Mr. Sgherzi: Exactly. I think really that's the major problem right there to be honest with you.

The Court: Thank you. Mr. Martin.

Mr. Martin: Well, your Honor has displayed a very extensive familiarity with the record, so I won't belabor the point except to say that I think there is undue emphasis placed on the concept of embezzlement here.

The Court: Well, I'm not finding embezzlement.

Mr. Martin: I understand that, your Honor, but I've explained and I thought I explained adequately that these takings were authorized pursuant to the power of attorney. There was a breach of fiduciary relationship, which is a civil problem. And I pointed out how under other cases—

The Court: Well, under traditional embezzlement law, the embezzler comes into possession of the property lawfully and then converts it.

Mr. Martin: Well, in any event, on the issue of evidence of transactions, I think your Honor is very familiar with it. Attached to the original objection at pages 248 [81] through 259 were copies of checks signed by Macfarland designated as loans to Cheng.

At pages 329 through 350 are copies of notes. The first one February, 1987, $250,000 signed by Cheng to Macfarlane. July 19, 1988, $600,000. There's another one page 331, one million dollars. There's another one which the record shows was prepared by Cheng's lawyer September 25th, 1987. It's a comprehensive note for $250,00. It was the context of this note that the documents referred to by the court were prepared evidencing an ongoing relationship, creditor/lender/borrower relationship, between Cheng and Macfarlane. And then there's the agreement which appears at page 333 dated July 31st, 1988, which again goes into a line of credit of up to $1,250,000.

I think there is no question that the record establishes that there was intended to be a debtor/creditor relationship, that the money was intended to be loaned to Mr. Cheng. I think the record also shows that it was misapplied by him, but that's not really relevant once the threshold issue of a debtor/creditor relationship has been shown.

The Court: I think that's right. And I went through the list of the assertedly uncontroverted facts set out in Exhibit 1 to the notice of this motion filed by the debtor and found that I could agree with each of those based upon the statements I've already made with respect to my tentative. And the same is true with respect to the conclusions of law, [82] including the burden issue. So every state has its remedy with respect to that.

Mr. Martin, will you prepare a proposed formal order and lodge it.

Mr. Martin: Thank you, your Honor.

Mr. Sgherzi: Thank you.

[83]

State of California)
County of San Diego)

I, Kathleen Cheyne, a shorthand reporter, do hereby certify that the foregoing hearing was taken before me at the time and place herein named; that said hearing was reported by me in shorthand and then transcribed through computer-aided transcription, and the foregoing transcript contains a true record of the said hearing.

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/s/ KATHLEEN CHEYNE
KATHLEEN CHEYNE